

Gas Geopolitics: Visions to 2030

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Working Paper #36

February 2005

This text will appear as Chapter 14 in the forthcoming book 'Natural Gas and Geopolitics' edited by David G. Victor, Amy M. Jaffe and Mark H. Hayes

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The studies presented in this book offer a wide array of detailed findings. Here we focus on four main results that, based on the studies, should dominate strategic thinking about the next three decades' shift to increasing reliance on natural gas:

- 1) An integrated global gas market will emerge, in which events in any individual region or country will affect all regions.
- 2) The role of governments in natural gas market development will change dramatically in the coming decades.
- 3) The rising geopolitical importance of natural gas implies growing attention to supply security.
- 4) The rapid shift to a global gas market is not a certainty. It depends enormously on creating the context in which investors will have confidence to deploy vast sums of financial and intellectual capital; it requires finding solutions to the adverse social and political consequences of developing natural resources in countries where governance is weak; and it assumes a continued pull from the growing world electricity sector.

EMERGENCE OF AN INTEGRATED, GLOBAL GAS MARKET

A major conclusion of the joint study is that a shift is taking place today from a gas world of previously, regionally-isolated markets to an international, interdependent, market of global gas. A series of developments – increasing demand, technological advances, cost reductions in producing and delivering LNG to markets, and market liberalization – is spurring this integration of natural gas markets. Such market interconnections will have large ramifications for both large gas consumers and producers.

Results from the study's economic modeling suggest that the shift to a global market will make each major consuming or producing region vulnerable to events in any region. Disruptions or discontinuities in supply or demand will ripple throughout the world market. Moreover, the timing of any major gas export project coming online will affect prices and project development in all regions. Policy makers now focus on the macroeconomic effects of variable oil prices; similar concerns will arise with the transition to gas.

Major consuming countries will have to learn to consider the interdependencies of a global gas market. While large gas importing countries have in the past been focused on key

supply relationships (see case studies, Victor/Victor; Hayes; and Mares), this point-to-point approach to project development is unlikely to prove as effective for the future where price and supply security in the gas market will become more like the commodity oil market of today.

According to base runs of the RWGT model, in a world of fully integrated natural gas markets, for instance, gas users in Japan will have a vested interest in stability of South American gas from the southern cone reaching the U.S. West coast; those in the United States will have concern about natural gas policy in Africa and Russia, and the EU will be compelled to monitor the political situation in gas-producing countries as remote as the Russian Far-East and Venezuela.

Russia will play a pivotal role in price formation in this new, more flexible and integrated global natural gas market, the model suggests. It was one of the first major gas exporters to the European market and could utilize the nascent European pipeline network taking shape alongside the rising Russian exports (see case study, Victor/Victor). Russia benefits not only from its location and size of resources but also from its status as the key incumbent. Throughout the model period to 2030, Russia is expected to be a very large supplier to Europe via pipeline, exceeding 50% of total European demand post 2020. The model suggests that Eastern Siberian gas will flow to Northern China by the middle of the next decade. Strategically positioned to move large amounts of gas both east and west, the presence of low cost Russian pipeline gas in both Asia and Europe will serve to link Asian and European gas prices. The model also suggests that Russia also will eventually enter the LNG trade via the Barents Sea, providing an additional link between gas prices in North America, Europe and Asia.

Other resource-rich nations, such as Iran and Saudi Arabia, could also become major players. However, they will be disadvantaged because they must bear the fixed costs of market entry due to lack of existing infrastructure to carry their gas to the lucrative European and Asian markets. The model estimates that their entry is delayed until demand rises sufficiently to accommodate those incremental supplies. Neither Middle East resource powerhouse is expected to be a major gas player in the next two decades, according to study predictions. Prolific Turkmen gas may also be slow to come to market due to political and economic barriers in moving that gas across rival Russia (see case study, Olcott).

The modeling work suggests that the United States market will remain a premium region as North American production fails to keep pace with demand, and high prices pull gas supplies from around the world. Alaska is an important source of future supply, flowing to the lower U.S. 48 states by 2015 and replacing dwindling supplies from western Canada. This new Alaskan source does not collapse North American prices that are, today, at all time highs. Nor do Alaskan supplies eliminate the need for imported LNG, which in 2003 accounted for just 2% of U.S. gas supplies but could grow to 4% in 2004 if available regasification capacity is utilized at full capacity.

The international gas industry is already responding to this integration of supplies and major gas consuming regions. As liquidity in the market and the number of available supply alternatives have grown, the average distance between neighboring suppliers has declined, creating new opportunities for price arbitrage. In this new market context, there will be a reduced need for long-term bilateral contracts to hedge risks (see working paper by Hartley/Medlock and Hartley/Brito). Expectations about the future market evolution are influencing investment and trading decisions today, and this in turn is accelerating the change in market structure—a self-fulfilling prophecy.

Such a transformation is already taking place in the world gas market. More international oil companies are investing in major natural gas infrastructure projects without the security of fully finalized sales for total output volumes. Instead, companies are counting on their own ability to identify end-use markets at some future time, closer in line to the investment pattern that characterizes development of multi-billion dollar oil fields. Expectations of a premium, liquid U.S. market are a key factor encouraging this change as was liberalization of certain European markets which allowed gas sellers to bypass European state gas monopolies and sell directly to large gas customers and power generators (see case study, Ball/Shepherd).

NEW MARKET STRUCTURES AND THE CHANGING ROLES FOR GOVERNMENTS

Throughout most of the historical development of the gas industry, government has played the central role in creating markets for gas as well as in directing gas supply projects. Government-owned enterprises have built and operated the infrastructures that were essential to distributing the large volumes of gas that has arrived with supply projects. Government-to-government agreements, usually backed with government controlled financing, have been essential cement for the producer-user relationships.

However, as market liberalization takes hold in many key gas consuming countries and global trading of natural gas expands, the role of government is changing—away from builder, operator and financier of gas projects and toward a greater role as regulator and creator of the context for private investment. Historical case studies have allowed examination of how this market-oriented structure—which itself is part of a broader trend in the organization of modern states and economies—will affect the incentives to create new, greenfield gas transportation networks that are essential if the world is to continue its rapid shift to gas.

In all the cases where gas has been supplied to a market that does not exist, case study findings suggest that governments have played a central role in “creating” demand for new import volumes of gas. Absent the state, very few, if any, of these projects would have been able to move ahead at the same speed or with the same volumes of deliveries.

Studies of the first-of-a-kind LNG export projects from Arun in Indonesia (1970s) and Qatar (late 1980s) to Japan show the importance of willing government to orchestrate the

investment—in these cases, the government of Japan and a small coalition of Japanese buyers. The first of these projects—Arun—rested on the willingness of the Japanese government (through MITI and Japan’s Export-Import Bank) to orchestrate the purchase of the gas and the timely construction of an infrastructure for utilizing the gas. The Japanese government provided crucial financial support as Japanese trading companies launched the Arun venture; the government’s interest was rooted in its high priority on energy security and a desire to diversify energy supplies away from coal and oil. In the Japanese context, as an island nation, the government supported an infrastructure that was not a gas pipeline transmission grid (as seen in Europe) but, rather, a network of LNG receiving terminals, serving a cluster of relatively isolated local markets. Constraints on moving gas between those markets helped each local monopoly protect its position and thus invest with confidence in long-term returns. Lack of similar government backing for proposed sales of Arun gas to California meant contracts to that market languished in the face of Japanese insistence that it be given the right of first refusal on any increased gas exports from Arun (see case study Lewis/von der Mehden).

Similarly, the role of the Japanese government and its buying coalition was important to Mobil Corporation’s ability to get the Qatargas project off the ground in 1987. Although the strength of MITI and other crucial arms of the Japanese government had weakened considerably as part of a broader effort to expand the role for market forces in the Japanese economy, the role of a Japanese buying consortium along with access to existing import infrastructure was critical to Qatargas’ success in gaining financing and sufficient sales contracts. The timing of the project coincided with a reduction in Japanese concerns about the political stability of supplies from the Persian Gulf with a rising U.S. military presence in that region (see case study, Hashimoto/Elass).

In the same vein, much of the variation in the outcomes of the two proposed projects to pipe gas across the Mediterranean in the late 1970’s is also due to the starkly different roles that the Italian and Spanish governments took towards the prospects of starting to import large volumes of gas. Like Japan, Italy was actively seeking gas imports and was willing to mobilize significant state resources to secure new energy supplies. Through its own export credit agencies, the government provided the bulk of financing for the Transmed pipeline project. And state-owned ENI was positioned at that time to orchestrate the Trans-Mediterranean (“Transmed”) pipeline project as well as the development of Italy’s domestic gas transmission grid. State backing allowed ENI to invest with confidence and provided cover for international lending. Spain, on the other hand, did not have supporting policies in place, and thus could not lead successful development of a major gas import project in the late 1970s and early 1980s (see case study, Hayes).

Importantly, other case studies show that the ready availability of large volumes of gas is not enough to create demand for gas in end-user markets. In markets where the state has avoided a central role in creating infrastructures, rapid gasification has not taken place. In 1990s Poland, for example, the large pipeline from Russia was constructed mainly to supply additional volumes of gas to the German market. Because it crossed Polish territory, large volumes were also

available to Poland—yet the Polish market has used very little of that available gas—despite take-or-pay contracts for Polish offtake. The Polish gas market stalled in large part because no entity in Poland was prepared to build the infrastructure needed to distribute gas (see case study, Victor/Victor).

Thus, case study findings sound caution about visions for rapid gasification in markets where gas delivery and domestic market infrastructure do not already exist and where the state is not prepared to back the creation of the gas delivery infrastructure. Indeed, the instance of most rapid gasification that is observed in any of the case studies is the one where the state played the most central role—the Soviet Union. A decision from the center to favor gas in the 1950s, orchestrated through central planning, catapulted gas from just 1% of total primary energy supply in 1955 to nearly one-third in 1980 (see case study, Victor/Victor). Of course, state intervention is usually not the most economically efficient nor the only way to create a market, but these case studies suggest that state intervention accounts for much of the observed variation in first gas projects.

In looking at the role of the state in gas market development, it is also important to examine the role of government in market regulation. The case study of the Southern Cone provides two contrasting examples. The GasBol pipeline, connecting Bolivia to Brazil, was a favorite of both governments and multinational development banks looking to support market reform, transparency and intra-regional trade in the aftermath of a bilateral peace treaty between Chile and Argentina. Under pressure from multinational organizations, market liberalizers and domestic trade groups, the Brazilian government forced state-owned Petrobras to contract for the bulk of gas purchases from the pipeline and also encouraged the company to provide financial support for the investments in field development in Bolivia to be sure that the project went forward. But the failure of demand for gas in Brazil to materialize—in part due to the failure of the Brazilian government to create a regulatory context that would allow gas-fired power plants to sell their electricity—meant that GasBol could not survive financially. Petrobras was left on the hook for volumes of gas it could not sell (see case study, Mares).

The GasAndes pipeline from Argentina to Chile indicates the types of projects that seem likely to emerge in the absence of direct state support. The GasAndes project, a small pipeline to connect gas fields in Argentina to a small number of power generators near Santiago, Chile, beat out its competitor, Transgas, because it was able to find private sector buyers and environmentally driven government support for a limited, strictly commercially-viable project. The liberalizing electric power market in Chile along with the tighter air pollution regulations in badly polluted Santiago created favorable conditions for the project.

In contrast, the Transgas project sought to build a much more elaborate gas distribution network south of Santiago, seeking to supply gas to new distribution companies that would serve industrial and residential gas consumers, in addition to new gas-fired power generators. A rival project, GasAndes, sought to supply just large electricity plants in Santiago directly. The Transgas project was more costly; payback would have occurred over a longer period and with

greater uncertainty. Transgas sought a concession from the government to allow it to recover investments in the gas distribution grid; as political efforts to get that concession foundered, the GasAndes project moved quickly ahead (see case study, Mares).

On the supply side, the role of government has been equally important. Even where private firms have actually made the investments in developing gas fields and in building the transmission infrastructure, governments have been essential guarantors of long-term contracts that, historically, have underpinned most large scale gas infrastructure investment. In the past, investor risk has been mitigated by “take-or-pay” contracts. But new, more flexible contracting is being pressed upon the industry as gas markets become more global and akin to a commodity. Gas-on-gas competition, new gas resale contract clauses and joint investor/host country spot marketing strategies are creating new uncertainties that are creating a new market structure for gas.

While the role of the state weakens, the key anchoring role for gas projects is shifting to the private sector. In the old world, the governments had deep pockets and a strategic vision that was organized around serving national markets and developing national resources. The development and implementation of this vision was often inseparable from the state-owned and supported enterprises whose charge it was to supply energy to the national market. In that world, projects were national ventures (see case studies, Hashimoto/Elass; Victor/Victor; Hayes).

In the new world, a handful of large energy companies with deep pockets and a similar strategic vision are taking over the role as creator and guarantor of the implementation process. These players are largely private, but they also include national energy companies that are now playing a larger role in the *international* marketplace—ENI, PetroChina, Petrobras and others. This shift to large energy companies, however, is likely to mean that infrastructure development will increasingly be driven by commercial interests rather than national energy security objectives (see case study, Ball/Shepherd).

The advent of new, more commercially oriented players dominating the gas scene will also change the nature of how contracts are negotiated and enforced. In the regulated, state-controlled environment, it was relatively easy for governments and their bidders to tailor the terms of gas trade agreements for political ends. But as gas markets liberalize—especially in Europe, where countries are small and borders are plenty—directed gas trade is harder to sustain, especially as provisions such as destination clauses are undone. In the emerging commercially-driven environment, the role of courts as enforcers has grown—made possible, in part, by legal reforms that have accompanied the shift to markets and given courts and quasi-judicial bodies, such as regulators, greater authority. Although the industry press is just now focusing on the implications of this shift, case study investigation on this issue suggest that this shift has been under way for more than a decade (see case studies, Ball/Shepherd; Hayes).

Ironically, the importance of existing contracts may lie less in their enforceability but, rather, in their ability to coordinate the “sinking” of investment. By facilitating the creation of

sunk costs, existing relationships act as a deterrent to others and a binding agent for the project investors. Once Italy had partnered with Algeria and had begun to lay pipe, the deal was sunk and there were huge incentives to continue cooperation (see case study, Hayes). Russia's contract with Poland partly deterred alternative (more costly) suppliers to that market, but the most effective deterrent existed only once the contract had focused investment on Russia's pipeline. The ultimate deterrent to Norwegian supplies to Poland was the fact "on the ground" of Russia's pipeline (see case study, Victor/Victor).

Another aspect of the sunk investment in the existing infrastructure is that it gives its owners a first mover advantage that will not be easily overcome by new gas market players. The base run of the RWGTM suggests that there are substantial advantages to first movers. For example, resource-rich players like Saudi Arabia and Iran must bear the fixed costs of market entry due to their lack of existing infrastructure. Early entry will require a sacrifice in prices, discouraging investment until market growth was strong enough to absorb excess alternative supplies and still accommodate incremental Saudi or Iranian supplies. Demand is unlikely to be high enough to support new entries until after 2020, according to modeling estimates.

With the exception of Russia, various case studies show that private commercial players have been better placed to position themselves as first movers than state gas concerns. Owners of Trinidad LNG were able to push Algeria's Sonatrach from lucrative U.S. East coast markets by creating lower costs (see case study, Ball/Shepherd). Nimble GasAndes beat out slow-paced Transgas, which had hoped to tap government support to create a market (see case study, Mares). A topic that remains to be explored is whether government-owned entities will be able to act as strategic players in the more competitive gas world or whether private commercial players will be able to organize competitive supplies to get to market more effectively, thereby leaving state monopolies to wait for long term market growth to make space for them to enter without the pressure of innovation.

GLOBAL GAS AND SECURITY OF SUPPLY

The shift from the highly structured gas world of government-backed bilateral, fixed priced contracts to a new world of private, market related contracts raises questions about national security of supply. Private sector participants have different interests from countries; they cannot be expected to consider automatically the energy security concerns of client nations as they are driven mainly by commercial considerations.

One area of attention is the potential formation of a gas cartel similar to OPEC. Concern for maintaining a secure supply of reasonably priced natural gas, which until now has taken a back seat to its oil sister, will increasingly be viewed as a vital national interest. In the past, gas users have feared interruption in vital gas supplies for a variety of reasons such as contract disputes between Algeria and its customers (see case study, Hayes), to political unrest in Indonesia (see case study, Lewis/von der Mehden) to transit country risk such as Ukraine and

Belarus for Russian exports (see case study, Victor/Victor). In addition to supply interruption fears, major gas consuming countries or regions worry that a key exporter such as Russia (to Europe) or group of exporters could exercise monopoly power to extract inflated rents for their product.

In May 2001 the Gas Exporting Countries Forum (GECF) held its first ministerial meeting in Tehran with the aim to enhance coordination among gas producers. Although the GECF ministers announced that they did not intend to manage production or set quotas, certain individual members of the group have debated the merits of exercising some form of market influence or control. Such ideas have nonetheless gained momentum since the group's first session. By its third session in Doha, Qatar, GECF had swelled to 14 members: Algeria, Brunei, Egypt, Indonesia, Iran, Libya, Malaysia, Nigeria, Oman, Qatar, Russia, Trinidad and Tobago, the United Arab Emirates and Venezuela (and one observer, Norway).

The GECF has already tried, unsuccessfully, to exercise some collective influence in the European market. GECF helped to catalyze formation of a working group headed by Russia and Algeria who sought to resist European Union (EU) attempts to outlaw destination clauses that prevent buyers from reselling gas. (The option to resell gas is a pivotal mechanism for market arbitrage and efficiency as it helps to prevent segregation of markets that allows gas sellers to exert monopoly power.) In another example, Egypt has sought a change in gas pricing systems that would end the link to crude oil prices with the aim of easing the penetration of gas into European markets. Both of these efforts, so far, have generated little practical change; a gas exporters' cartel remains at a theoretical stage (see working paper by Soligo/Jaffe).

The Gas Exporting Countries Forum has too many members with diverging interests to exert effective constraints on capacity expansion projects in the near term. It is likely to be a decade or more before they can assert sustained monopoly power in world gas markets, leaving consumer countries ample time and opportunity to adopt countermeasures. It will take many years to work off a plethora of supplies from within major consuming regions and small competitive fringe producers.

Gas suppliers might be able to extract short term rents in particular markets by manipulating supplies into markets where alternative supplies are not available. Algeria used this position to force higher prices on the Italian and French markets in the 1970s, but Algeria quickly suffered when circumstances changed. Over the long term, Algeria has paid a high cost due to the reputation it gained as an unreliable supplier (see case study, Hayes). The same Algerian effort to lift prices also contributed to Algeria's loss of share in the U.S. market, which created an opening that new export projects from Trinidad eventually filled (see case study, Ball/Shepherd).

Over the long term, gas exports may eventually concentrate in the hands of just a few major producers, which could make it more feasible for a group of gas producers to restrain capacity expansion to gain higher rents. The overall distribution of world natural gas reserves is

more concentrated than the distribution of oil reserves. The two countries with the largest gas reserves, Russia and Iran, have roughly 45% of world natural gas reserves while the two countries with the largest oil reserves, Saudi Arabia and Iraq, have just 36% of world oil reserves. The five-country concentration ratio for the two fuels is roughly the same at 62%. However, the regional concentration of gas resources is more diverse. Middle East countries hold only 36% of natural gas reserves – as opposed to 65% of oil reserves. The former Soviet Union represents a second equally important region for gas production and exports (see working paper by Soligo/Jaffe)

Indeed, the base case of the model estimates that Russia will become a very large supplier to Europe via pipeline, exceeding 50% of total European demand after 2020. This dominance could leave Russia in a position to curtail capacity additions and boost rents for its gas.

Policy responses to the risk of cartelization are numerous. Among them is the privatization of gas reserves and the gas transport networks in producer countries. All else equal, it is probably easier for national, state-owned, producers to participate in a cartel than for privately owned firms that might have different objectives from the state. If numerous private Russian gas producers emerge, for example, it will be more difficult to reconcile their conflicting corporate ambitions with those of a cartel—especially if pipeline operators are constrained through effective regulation for using their network for market manipulation.

As the case studies show, diversity of supply is an important protection from rent-seeking behavior both of both gas exporters and transit countries. When Ukraine first interrupted Russian gas exports in 1995, European buyers who redoubled their efforts to diversify found many alternative suppliers, confirming the importance of market reforms that encourage multiple supply sources and gas on gas price competition. Moreover, the declining costs of LNG and pipeline trade mean that markets will be contested by ever-distant arbitrage potentials.

Over the longer term, as gas production capacity peaks in the various regions containing more limited gas production potential, direct competition between key LNG suppliers in the Middle East and Africa and Russian pipe gas may appear to key players as counterproductive, creating an opportunity for more strategic cooperation among Russia and other major gas exporters. However, the power to set gas prices will also be limited by the fact that gas consumers have the option of shifting to other fuels. The ability to switch fuels suggests the need for policy makers to promote a diversity of existing as well as new energy sources.

RISKS TO THE GREATER GAS VISION

For many analysts, the assumption that the world will shift to gas is rooted in current trend lines and economic modeling that, understandably, do not fully reflect the myriad of political and institutional factors that often play a large role in determining where gas investments occur. Thus, the bright gas future is by no means assured.

First, the vision for gas depends enormously on investor confidence and the supply of vast sums of financial and intellectual capital. A plethora of studies has confirmed that world gas resources are abundant, but many of those resources are not in countries that have traditionally been attractive for private investors. The capital intensive nature of gas and the long payback periods typical of gas projects—15 to 20 years or longer for some of the most complex projects—makes investors especially wary.

Second, developers of gas resources may run afoul of concerns about mismanagement of gas revenues, intra-state disputes over rents, harm to indigenous communities and other afflictions that often get the label: “resource curse.” While the Arun case study concludes, for example, that non-governmental organizations (NGOs) and social discontent had less impact on Arun development in the 1970s because critics had yet to organize themselves sufficiently politically to provide significant impediments to the Arun operation. By 1998, agitation in Aceh where Arun was located became so severe that operations were temporarily suspended and led finally to full-scale central government military action against local armed groups (see case study, Lewis/von der Mehden).

The case of Arun may be a telling sign of an era coming to an end—an era where developers of these resources faced much less external scrutiny on their operations and where states, themselves, directed many resource development projects. It is plausible to argue that neither of those two conditions will hold in the future. With the advent of revenue management schemes on the Chad-Cameroon pipeline, in Azerbaijan, and other such arrangements emerging for oil resources, it is plausible to expect that gas projects could some day face similar intervention.

In addition to more challenging local politics, visions for gasification may also run afoul of difficulties in siting major gas infrastructures, especially amid emerging worries about terrorism. LNG is the key to the shifting structure of the world gas market—toward a global market—and the U.S. market is a keystone to that development. Yet today the developers of LNG projects are facing a string of failures and political difficulties in siting LNG regasification facilities in nearly every part of the U.S. market except the Gulf coast.

Finally, the case studies also underscore that since around 1990 much of the dash to gas has depended on expectations about electric power markets.

The conventional wisdom that gas is favored for electricity has been shaped by the experiences in England and Wales, the United States, and several other markets. In many, gas has gained due to tighter environmental rules. It has also gained because liberalization has created additional pressure to select the least cost options. But close attention must be given to markets where gas-fired generation is not the current low marginal cost supplier or where electricity demand might be constrained by other factors.

In Poland, the dominance of incumbent coal-fired power plants, the vast over-supply of electric generating capacity and the lack of strong government incentives for gas have made it difficult for Russian gas to enter the market (see case study, Victor/Victor). In Brazil, a darling for potential investors in the 1990s, the recent collapse of economic growth, combined with dominance of incumbent hydropower and an unfavorable regulatory setting, has impeded the entry of gas (see case study, Mares).

It is not yet clear whether gasification in other emerging markets—such as China and India—will follow the examples set in the United States and England (where electrification and liberalization favored gas for electricity) or Poland and Brazil where governments failed to institute the incentives for a push to gas. We end, thus, with a note of caution, especially when projections such as the IEA's World Energy Outlook envision that two thirds of the incremental demand for gas will come from electric power.